UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

UNITED STATES ENVIRONMENTAL PROTECTION AGENCY

OFFICE OF
WATER

Assistance Dispute of NORTHEAST OHIO REGIONAL SEWER DISTRICT Docket No. AA-90-AD14	Decision of the Assistant Administrator

DIGEST NOTES

GRL-040-850-000 Scheduled Completion Date

Great weight should be given to a contemporaneous change order for a contract time extension approved by the project officer (whether employed by EPA, a delegated State, or the U.S. Army Corps of Engineers) where there is evidence that the project officer took a "hard look" at the need for the time extension. In such situations, the project officer's determination should be dispositive unless there is strong evidence to the contrary.

GRL-040-050-000 Allowability of Costs - Allocation

In projects involving multiple construction contracts where engineering costs are not accounted for on an individual contract basis, and where some but not all contracts have qualified for a time extension, allowable engineering costs may be determined through the use of a construction ratio formula, as long as it is reasonable to assume that the level of engineering services was similar for each contract.

PETITION FOR REVIEW

By letter dated November 26, 1990, the Northeast Ohio Regional Sewer District (the District) requested that I review a decision issued by Mr. Valdas V. Adamkus, Regional Administrator of Region V. Mr. Adamkus' decision, dated September 21, 1990, disallowed certain costs associated with the construction of the district's Easterly Wastewater Treatment Plant because some costs were incurred after the accepted contract completion date, and other costs lacked the documentation necessary to allocate them between contracts.

BACKGROUND

On September 7, 1977, EPA awarded Step 3 grant C-391127-02 to the District to construct an effluent filtration system and chlorination system at its Easterly Wastewater Treatment Plant. The grant amount was $8,997,372, representing 75 percent of the eligible construction costs.

The project was divided by the District into two construction contracts: a general construction contract (Contract 139A) and an electrical construction contract (Contract 139B). According to the District, this was done in order to comply with Ohio law and to facilitate competitive bidding. The District, however, kept its cost records by project rather than by individual construction contract.

Each of these contracts had an original contract completion date of January 16, 1981. The District received approval from the U.S. Army Corps of Engineers (COE) to extend Contract 139A to July 1, 1981.[1] A change order requesting an additional 289 days for Contract 139A was not approved by the COE, but is not in dispute. With regard to Contract 139B, the COE first approved a change order (Change Order No. 8, Extra Order No. 7) extending the completion date 352 days to January 1, 1982. The District requested a further extension of 455 days to March 31, 1983 (Change Order No. 11, Extra Order No. 8), but the COE rejected the full request and approved only 257 days, thus extending the completion date to September 14, 1982.

The Office of the Inspector General (OIG) conducted an audit of the grant project. The auditors' report, prepared by an outside firm acting at the direction of the OIG, was used to prepare a final audit report, dated April 22, 1988, which questioned certain claimed costs and set aside other costs. In particular, the auditors determined that inadequate justification had been provided for a 186 day period (July 1, 1981, to January 1, 1982) included within the 352 day extension period (January 16, 1981, to January 1, 1982) approved for Contract 139B pursuant to Change Order No. 8. As a result, the auditors subtracted the 186 questioned days from the accepted contract completion date of September 14, 1982, and established a revised contract completion date for Contract 139B of March 16, 1982.

The Region V Disputes Decision Official (DDO) concurred with the audit findings and disallowed $49,490 in engineering costs, including project inspection costs and related indirect costs, because they had been incurred after March 16, 1982, the

[1] Pursuant to a memorandum executed on June 23, 1980, EPA delegated to the COE the power to review and approve contract change orders, including changes in contract completion dates.

completion date accepted by the auditors for Contract 139B. The DDO further concurred with the audit findings and disallowed an additional $75,103 in engineering costs, including project inspection costs and related indirect costs, incurred between July 1, 1981, the accepted completion date for Contract 139A, and March 16, 1982, the accepted completion date for Contract 139B. Because the District kept its records by project, rather than by contract, the auditors could not determine if any of the costs incurred between these dates were attributable to Contract 139A, and thus were unallowable because they had been incurred after July 1, 1981, the accepted completion date for that contract. In the absence of documentation that all of the work done between these dates was attributable solely to Contract 139B, the DDO disallowed all of these costs. As a result of these findings, by final determination letter dated December 21, 1988, the DDO disallowed costs totaling $124,593.

By letter dated January 19, 1989, the District requested review of the DDO's decision by the Regional Administrator. By decision dated September 21, 1990, the Regional Administrator affirmed in part and reversed in part the DDO's decision. The Regional Administrator affirmed the disallowance of $49,490 in costs incurred after March 16, 1982, the contract completion date accepted by the auditors and the DDO for Contract 139B. With regard to the costs incurred between July 1, 1981, the accepted completion date for Contract 139A, and March 16, 1982, the accepted completion date for Contract 139B, the Regional Administrator reversed the DDO's determination that all of the costs incurred during that period must be disallowed. The Regional Administrator held instead that, in the absence of documentation adequate to specifically allocate costs between allowable and unallowable portions of a contract, the costs may be allocated based upon a construction ratio, as long as alternative documentation shows that the work was otherwise eligible and was not incurred due to grantee mismanagement or the contractor's failure to perform. A construction ratio prorates project inspection and related engineering costs, utilizing a ratio of the allowable construction costs attributable to the contract, divided by the total costs (allowable plus unallowable) for which the engineering services were performed. Applying this methodology to determine the percentage of engineering costs attributable to Contract 139B, the Regional Administrator determined that 29.8 percent, or $22,381 of the total engineering costs of $75,103 incurred during the period between the two contract completion dates, was allowable, and the remaining $52,722 was not allowable. The Regional Administrator thus sustained a total disallowance of $102,212.

By letter dated November 26, 1990, the District requested review and reversal of both parts of the Regional Administrator's decision. My staff met with representatives of the District on August 26, 1992, at which time the District presented further arguments and information in support of its petition.

DISCUSSION

Completion Date for Contract 139B

While the auditors accepted a portion of the time extension approved in Change Order No. 8 (166 days from January 16, 1981, to July 1, 1981), they questioned the remaining 186 days (July 1, 1981, to January 1, 1982) included within the extension period. The auditors questioned the 186 day period because they had determined that the only basis for the delay was the contractor's failure to sign the change order, and that this was not adequate justification to support the extension. In its petition for review, the District strongly objected to this conclusion.

Our review of the record supports the position of the District. While the documents cited by the auditors do indicate that there was a delay in obtaining the contractor's signature, they do not indicate that this was the reason that the time extension was required. The record indicates, instead, that the extension was requested and approved in order to permit completion of specific work elements included in the original contract. For example, in response to the audit report, the District stated that the extension was not requested because of a signature delay but that, to the contrary, the extension was:

> ...approved by the COE on the merits of significant outstanding Contract 139B work elements. These contract items consisted of such significant aspects as the interfacing of new electrical power feeds with Cleveland Municipal Light and Power, testing and start-up issues with the return sludge pumps, testing and start-up issues with blower motors, issues with the removal and disposal of PCB-containing transformers, etc. Letter from Erwin J. Odeal to Martin W. O'Neill (March 10, 1988) at 2.

In addition, in a subsequent letter to EPA, the District responded to questions posed by Region V with regard to the audit findings. Region V had asked why the days included in the extension period from July 1, 1981, to January 1, 1982, were necessary and whether there was more work required than that which had been completed by July 1, 1981. The District responded as follows:

> ...Extra Order No. 7 (Change Order No. 8) was not an "additional work" related time extension. Extra Order No. 7 extended the contract duration by 352 days for the completion of original contract work elements....The "good cause" [for the time extension] in the instance of Extra Order No. 7 was the recognition that numerous factors and circumstances combined to impact the critical path performance of this contract. The key point to be emphasized is that Extra Order No. 7 afforded an extended time frame to the contractor to complete original contract work elements. To document this continuum of the Contract 139B work effort through the period of Extra Order No. 7, we have attached as Exhibit 2, copies of the District's Resident Engineer's Daily Reports for the period of August 3, 1991, through January 1, 1982. You will note that the Reports document the on-going contract effort, the most notable work elements being the blowers, return sludge pumps, and the interfacing of new electrical power feeds with Cleveland Municipal Light and Power..." Letter from James E. Tubero to Linda Haile (September 1, 1988) at 2.

Attached as an exhibit to the letter were the resident engineer's daily reports for the period in question, which confirm that the work described in the letter was performed during this period. Id. at Exhibit 2. Thus, we agree with the District that the signature delay was not the basis for the extension.

The District's petition further argues that, in any case, the auditors should have refrained from questioning the contract completion date, under the Agency's policy of deferring to contemporaneous technical judgements by the project officer. Indeed, the District asserts that the application of the principles of that policy requires reversal of the Regional Administrator's decision.

The District's argument refers to a long-standing Agency policy that is most clearly articulated in a guidance document entitled "Costs Incurred After Contract Completion Date," signed by James A. Hanlon, Director, Municipal Construction Division, and Kenneth A. Konz, Assistant Inspector General for Audit, Office of the Inspector General. The guidance is based on Decision 13/14 of the Audit Resolution Board, dated February 24, 1984, which held that:

> Evidence of affirmative management decisions by EPA or a delegated State on the specific item questioned by audit should carry great weight in the decision whether to allow the relevant questioned costs.

Since the guidance document was issued on October 1, 1990, a few days after the Regional Administrator issued his decision on September 21, 1990, a threshold question is whether the guidance applies to this decision. The guidance states that it is:

> ...intended to address existing disputes in the Subpart L/Subpart F process involving the allowability of post-scheduled contract completion A/E fees. It also applies to disputes which may arise in the future regarding change orders executed prior to the date of this guidance. Guidance at 3.

Although the Regional Administrator's decision was issued before the guidance, and the Regional Administrator's decision is normally considered the final Agency action, the District had not exhausted all of its procedural rights at the time the guidance was issued, since the opportunity remained to file a petition for discretionary review by the Assistant Administrator for Water. Therefore, this dispute was an "existing" dispute within the meaning of the guidance, and the guidance applies.

The guidance first restates EPA's longstanding policy that project inspection costs incurred after the scheduled contract completion date are allowable, provided that the grantee can demonstrate that:

1. The costs were not incurred as a result of grantee mismanagement or contractor failure to perform, but rather were attributable to justifiable extensions to the time of performance; and,

2. The costs were otherwise reasonable, necessary, and allocable to the project.

The guidance then goes on to discuss (1) the type and level of showing necessary to justify construction contract time extensions in specific situations; and (2) the factors to be considered in determining whether inspection costs incurred after the original contract completion date are otherwise reasonable and necessary. Since no issue has been raised in this dispute about the reasonableness or necessity of the costs in question, this Decision will not deal further with the second part of the policy.

With respect to justifications for time extensions in cases (such as here) where a change order was contemporaneously approved, the guidance states:

> Great weight should be assigned to contemporaneous change orders approved by a delegated State, the COE, or an EPA project officer (any of which is hereafter referred

> to as project officer approval), where the file reveals the project officer conceptually adhered to the Change Order Guide by taking a "hard look" at the need for a contract time extension and whether costs claimed were reasonable and necessary. For example, if there is evidence in the project file showing that the project officer carefully considered: the need for the time extension, the length of the extension, and the allowability of A/E fees and other expenses associated with the extension, then such contemporaneous project officer approvals should not be second guessed. Therefore, change orders with this support should be dispositive unless there is strong evidence to the contrary. Guidance at 4.

Briefly stated, the guidance specifies that where change orders are contemporaneously approved after a "hard look," the approval should be dispositive, unless there is strong evidence to the contrary. A "hard look" should be characterized by three elements.

The first element of a "hard look" is whether the project file indicates that the request for a change order was explicitly considered. The record indicates that COE officials were actively involved in deliberations concerning the need for the extension. In particular, memoranda prepared by both the District and the COE indicate that William F. Carter, the project manager for the COE Cleveland Area Office, was present at a meeting on August 11, 1981, which was called to discuss, among other issues, the interface problems with Cleveland Municipal Light and Power, the disposal of PCB-containing transformers, and the extension of the contract to provide for additional work on the blower motors. Memorandum from Richard Schmitz to Charles Vasuika (August 13, 1981); Memorandum to the file from William F. Carter (August 13, 1981). Mr. Carter's memorandum specifically indicates that the need for the extension was discussed, that the estimated time of completion of the work was December 1981, and that time was included for "additional work on the blowers." A handwritten note in the COE project file further confirms that COE officials specifically approved the time extension.

The <u>second</u> element of a "hard look" is whether the COE possessed reliable information on which to base a review of the request. In this instance, the change order review and final approval process had been delegated by EPA to the COE because the COE's "close involvement in the field" with the project would "help assure efficient implementation of the mission of managing project construction in accordance with approved plans and specifications and consistent with sound engineering and

construction practice." Letter from Charles J. Poremba to Louis V. Corsi (August 12, 1980). The record confirms the almost continual presence of the COE at the site. See letter from Paul T. Murphy to LaJuana S. Wilcher (July 12, 1991). Because of the COE's close involvement in the project, we have concluded that the COE was in possession of reliable information on which to base a review of the request.

The third element of a "hard look" is whether the request was subjected to a critical review. The record in this case indicates that COE officials carefully considered the basis for the time extension, the length of the extension, and the allowability of expenses associated with the extension. Indeed, the COE approved an extension shorter than the one requested by the District.

In summary, in this discussion of the completion date for Contract 139B, we have concluded that: (1) adequate documentation exists to support the time extension approved in Change Order No. 8; and (2) the COE approved the Change Order after a "hard look," and its contemporaneous decision should be dispositive.

In the absence of credible evidence to the contrary, we have accepted the contract completion date extensions approved by the COE and have reversed the Region's disallowance of $49,490 in costs incurred after the Region's accepted contract completion date of March 16, 1982.

Utilization of a Construction Ratio to Determine Allowable Costs

In addition to demonstrating a justifiable reason for the time extension, the guidance requires that a grantee demonstrate that the costs incurred are otherwise reasonable, necessary, and allocable to the project. Here, the District seeks reversal of the Region's disallowance of a portion of the engineering expenses, including project inspection costs and associated indirect costs, incurred between the earliest (July 1, 1981, for Contract 139A) and the latest (March 16, 1982, for Contract 139B) contract completion dates. Because the District's choice of recordkeeping methods did not permit the assignment of costs to a particular contract, the Region utilized a construction ratio formula to allocate the costs between allowable and unallowable portions of the contracts.

Contrary to the District's allegations, merely because costs are grant eligible does not make them automatically allowable. Award of a Federal grant does not guarantee that all eligible costs will subsequently be considered allowable, nor that costs will be exempt from subsequent review, audit, or disapproval. Construction grant expenditures are clearly subject to a cost review and final audit after project completion, in accordance

with the grantee's express commitment to repay grant overpayments and unallowable costs. 40 CFR 30.615, 40 CFR 30.820(b), 40 CFR 35.945(c);[2] Northeast Ohio Regional Sewer District v. Reilly, No. 1:90CV1229, slip op. at 2 (N.D. Ohio, Jan. 21, 1993). More specifically, a change order approval or grant amendment does not automatically make a cost allowable or preclude EPA from recouping any costs that are subsequently determined to be unallowable. Luce County Department of Public Works, Michigan, 05-90-AD10 (December 20, 1990; Assistant Administrator review denied November 1, 1991).

Furthermore, while it is true that EPA's recordkeeping regulations refer to "project" and "award," and not specifically to contracts, they do clearly require that the grantee maintain a financial management system that records information in a manner sufficient to reflect the disposition of the assistance. 40 CFR 30.805(a). EPA's regulations "specifically place a documentation burden of proof" upon the District. Northeast Ohio Regional Sewer District, slip op. at 5. The recordkeeping system must provide a procedure for determining the allowability and allocability of costs, including the appropriate allocation of costs between allowable and unallowable items. 40 CFR 30.800(f); 40 CFR 30.705(b); Village of Iuka, Illinois, 05-91-AD04 (September 24, 1991; Assistant Administrator review denied May 5, 1992). The grantee is held to knowledge of the recordkeeping regulations at the time of grant acceptance. 40 CFR 30.705(e). It is undisputed that the contracts at issue here had different completion dates and thus different periods during which costs were eligible for reimbursement. It is likewise undisputed that the accounting system chosen by the District failed to provide documentation of what work was being done at which time, and thus could not ascribe costs to a particular contract. As a result, the District failed to "provide appropriate documentation to satisfy its burden as grantee under the...regulations." Northeast Ohio Regional Sewer District, slip op. at 6.

However, even in the absence of documentation with regard to the allocability of costs, such costs may be determined to be allowable through the use of a rationally-based construction ratio to apportion allowable and unallowable costs. The guidance specifically provides for the use of such a ratio where, as here, the project involves "multiple construction contracts where A/E fees are not accounted for on an individual

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[2] The grant at issue here was awarded on September 7, 1977, and the substantive regulatory provisions to be applied are those in effect at the time of grant award. Therefore, regulatory citations are to those in effect on that date: The general grant regulations published on May 8, 1975, and the construction grant regulations published on February 11, 1974, unless otherwise noted.

contract basis and where some but not all of the contracts qualify for a time extension." Guidance at 6. The guidance permits the use of the construction ratio "so long as it is reasonable to assume the level of services is consistent across the contracts." Id. at 6.

In the absence of detailed cost records that segregate engineering work hours, tasks, and related costs, EPA has consistently used a construction ratio formula to determine allowable project inspection costs. The formula looks at the ratio of allowable construction costs to total construction costs (construction ratio). The construction ratio is then multiplied by the grantee's total project inspection costs (for the time period in question) to determine the allowable portion of the inspection costs. Allegany County Sanitary Commission, Maryland, 03-88-AD-20, 03-88-AD22, 03-88-AD23 (September 28, 1990; Assistant Administrator review denied November 1, 1991); Village of Jonesville, Michigan, 05-88-AD10 (May 8, 1989; Assistant Administrator review denied December 17, 1990; Assistant Administrator reconsideration denied August 22, 1991); City of Osceola, Missouri, 07-89-AD07 (September 28, 1990; Assistant Administrator review denied November 1, 1991). In the absence of adequate documentation of costs by the District, we affirm the Region's application of the construction ratio to the costs at issue here. Furthermore, since we have accepted September 14, 1982, the contract completion date previously approved by the COE, the construction ratio is to be applied to the disputed costs incurred during this additional contract period as well.

DECISION AND ORDER

I have reviewed the Regional Administrator's decision, and make the following determinations:

1. Where, as here, the file reveals that the COE took a "hard look" at the need for a time extension, the COE's determination should be dispositive unless there is strong evidence to the contrary. Therefore, we accept the contract completion extension date of September 14, 1982, previously approved by the COE for contract 139B, and project inspection costs for Contract 139B are allowable through that date.

2. The Regional Administrator correctly determined that application of the construction ratio to the disputed costs was appropriate.

3. The construction ratio is also to be applied to the disputed costs (engineering expenses, including project inspection costs and related indirect costs) incurred during the additional contract extension period (March 16, 1982, through September 14, 1982), and the disallowance is to be adjusted to reflect this recalculation.

CONCLUSION

The Regional Administrator's decision is hereby modified in accordance with the determinations set forth above. In all other respects, the Regional Administrator's decision remains the final Agency action, pursuant to 40 CFR 30.1225.

JUN 11 1994

Date

Bob Perciasepe

Robert Perciasepe
Assistant Administrator

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